

29 August 2008

Mr John Hawkins  
Committee Secretary  
Senate Economics Committee  
Department of the Senate  
PO Box 6100  
Parliament House  
Canberra ACT 2600

Dear Mr Hawkins

### **Senate Inquiry into Disclosure Regimes for Charities and Not-for-Profit Organisations**

The Institute of Internal Auditors-Australia (IIA-Australia) is the professional body representing and supporting Australian internal auditors. With more than 3,200 members in all states and territories across Australia, our membership is made up of internal auditors in all sectors.

IIA-Australia is the Australian affiliate of the global Institute of Internal Auditors (The IIA) which represents more than 160,000 members in 165 countries around the world. The IIA sets the global standards for internal auditing and is a key participant in local and global standards on internal control, risk management, governance and related matters.

As the peak profession responsible for providing organisations with assurance over the adequacy and effectiveness of their systems of risk management and internal control, IIA-Australia has a strong interest in promulgating best practice in all sectors and jurisdictions in this area for the ultimate benefit of these organisation's stakeholders.

While the NFP sector makes a great contribution to Australian society, clearly its practices and requirements in this area are lagging. While pockets of excellence exist in this sector, they would appear to be the exception rather than the rule.

Our submission contains nine recommendations together with supporting analysis.

We congratulate the Senate Committee for undertaking this Inquiry and would be happy to explain our submission further if desired. For further information, please contact our Technical and Policy Director, Todd Davies on (02) 9267 9155.

Yours sincerely



Christopher McRostie  
Chief Executive Officer

## BACKGROUND

### SENATE INQUIRY

On 18 June 2008, the Senate referred the Disclosure regimes for Charities and not-for-profit (NFP) organisations to the Senate Standing Committee on Economics for report by the last sitting day of November 2008. The inquiry aims to examine:

- a. the relevance and appropriateness of current disclosure regimes for charities and all other not-for-profit organisations;
- b. models of regulation and legal forms that would improve governance and management of charities and not-for-profit organisations and cater for emerging social enterprises; and
- c. other measures that can be taken by government and the not-for-profit sector to assist the sector to improve governance, standards, accountability and transparency in its use of public and government funds.

### IIA-AUSTRALIA SUBMISSION

The Institute of Internal Auditors-Australia (IIA-Australia) is the professional body representing Australian internal auditors. It is the Australian affiliate of the global Institute of Internal Auditors (The IIA). IIA-Australia aims to inform and educate stakeholders on best practices in internal control, risk management, internal audit and related matters, drawing on an extensive body of local and international knowledge.

Effective corporate and enterprise governance is fundamental to the operation of our profession, and hence IIA-Australia has a keen interest in the promulgation of best practices in all sectors and jurisdictions.

IIA-Australia has three policy principles which we believe are relevant to all organisations, in all sectors where there is a separation of management from ownership and/or stewardship:

- An Audit Committee or other board subcommittee with appropriate accountabilities, composition and skills is fundamental to the effective oversight of any organisation when there is a separation of management from ownership and/or stewardship.
- A well run internal audit activity<sup>1</sup> is essential to enabling the Audit Committee and executive management to fulfil their duties in relation to internal control, risk management and related matters. This is achieved by providing an independent and objective review of the organisation's risk management and internal control systems.
- Provided an Audit Committee is appropriately constituted, reporting lines for the head of Internal Audit to the Audit Committee allow for frank and fearless advice to the Audit Committee and are an important deterrent to perpetration of executive fraud.

We believe that these principles provide the framework for effective self-regulation by organisations in all sectors while also addressing many of the points raised by the Senate Inquiry. These principles are important to effective enterprise governance, and hence we recommend that the

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<sup>1</sup> The IIA uses the term "activity" to recognise that an internal audit function may be performed in-house, or provided by an external service provider.

recommendations in this submission be considered together rather than in isolation. Implementing a subset of these recommendations could result in sub-optimal outcomes for NFPs and their constituents.

## WHY THIS IS IMPORTANT TO NFPs

NFPs<sup>2</sup> are important to many aspects of Australian life. Increasingly NFPs are required to deliver services, manage significant funds (including public monies) and engage in more complex activities than ever before. This is also occurring at a larger scale across the sector and within organisations, which results in a need for heightened enterprise governance. While such events are rare, the NFP sector is vulnerable to the risks of employee fraud, misadministration, insolvency, financial loss or taking on risks which are not well understood or managed.

Effective organisation, oversight and risk management practices are critical to these organisations' ongoing viability, public trust and service delivery. The goal of most NFPs should be on high performance for the benefit of their stakeholders, supported by effective governance without excessive management and governance costs.

While evidence is only anecdotal, based on our observations the NFP sector significantly lags other sectors in respect of effective enterprise governance, which means that these organisations may be exposed to unnecessary risk. Our submission is framed with these factors in mind.

## KEY ISSUES FOR NFP REGULATION

### MULTIPLE JURISDICTIONS AND ENABLING ACTS

In framing our submission we note that NFPs have been constituted and can be constituted under a range of Acts. This raises a number of issues:

- There is an increasing trend for boards in all sectors to draw on experienced non-executive directors to provide appropriate oversight, self discipline, insight and enterprise governance. Such experience can provide a valuable contribution to these organisations in a range of areas including advice on risk management and internal control.

There is an increasing trend for non-executive directors to sit on multiple boards in different sectors to ensure that they can provide a broad spectrum of insight which is current and timely.

The duties and obligations of elected representatives, members of governance and oversight bodies, directors, management and officers may vary based on the particular piece of enabling legislation under which the entity is incorporated. As such, it is difficult for directors to be across all of these requirements in detail, leading to a potential focus on compliance with these regulatory nuances rather than on effective stewardship. While some nuances may be important to some jurisdictions and organisations, the presence of multiple regulatory regimes can be counterproductive, and can also act as an impediment to portability of Director and Officer skills.

- Variability in regulation can also pose significant challenges and cost burdens for organisations which operate in multiple jurisdictions and territories.
- Variability leads to inconsistent frameworks and approaches to governing organisations. By definition, variability suggests that some jurisdictions and enabling Acts may be weaker than

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<sup>2</sup> For the purposes of this submission we take NFPs to include all not-for-profit organisations whether charities, member based organisations, NGOs, clubs or other incorporated associations.

others, and may not address some aspects which would normally be expected of public institutions.

- Significant guidance and training infrastructure is in place to assist Directors and Officers to meet their requirements for ASIC regulated entities. It may not be practical to provide this level of support for Directors and Officers covered by different enabling legislation and equip them adequately for these roles.

As a principle, we encourage regulators to harness and enhance existing training, guidance & standards rather than replicate it for reasons such as those highlighted above.

*Recommendation 1: Rationalise or harmonise the current range of enabling legislation for NFPs to bring all NFPs up to a common minimum standard.*

*Recommendation 2: Harmonise enabling legislation with the Corporations Act to ensure consistency of duties for Directors and Officers. In achieving this aim it may make sense for this to be done within specific provisions of the Corporations Act, and for entities to be migrated to the Corporations Act and overseen by ASIC.*

## EFFECTIVE BOARD OVERSIGHT

The governance of and disclosure regimes of NFPs should be distinguished from the corporate sector in several respects:

- Listed companies are required to comply with or explain non-conformance with the ASX Corporate Governance Council's recommendations. These are a set of broad recommendations which have been agreed by 21 constituent bodies as being appropriate for most companies in most circumstances and hence are generally relevant for the NFP sector.

As these recommendations and disclosure regime only apply to listed companies, no such disclosure requirements are in place for NFPs.

- This disclosure based regime works on the assumption that the market will impose appropriate scrutiny, and therefore there is an assumption that the market has the time, inclination and aptitude to engage with companies, rather than "vote with their feet" by opting out or selling their shares.

IIA-Australia does not believe that a disclosure based regime for enterprise governance is likely to be effective or appropriate for the NFP sector, and that such an approach would be likely to generate reporting that is not acted on, and be a distraction from core business for NFPs.

- Within this context however, IIA-Australia recognises that one-size does not fit all in relation to enterprise governance, and that boards should be given discretion to put appropriate approaches in place for the organisations for which they are responsible.

Such self-imposed discipline by organisations requires the existence of a competent, experienced board with the authority to act. Given that many board positions in the NFP sector are often pro-bono and often based on interests in outcomes rather than as a professional responsibility as a director, regulatory involvement may be required.

*Recommendation 3: NFP Boards be required to put appropriate skills and structures in place to enable effective self regulation to the extent practicable, however some governance requirements such as those highlighted in this submission may need to be mandated by regulation rather than by disclosure.*

*Recommendation 4: NFP Boards be required to constitute an Audit Committee or other board subcommittee with appropriate accountabilities, composition and skills to enable effective oversight of matters normally dealt with by Audit Committees in the private sector. The Audit Committee duties should be set out as a sub-set of the duties of the Board.*

## EFFECTIVE RISK MANAGEMENT AND INTERNAL CONTROLS

Effective systems of risk management and internal control are important to the ongoing performance of any organisation. These systems help the organisation anticipate and manage issues before they arise including:<sup>3</sup>

- Strategic Risk – ensuring that the circumstances facing the organisation in the medium and long term are understood and managed
- Operational risk – ensuring that the organisation is running efficiently and effectively with minimal disruption and that risks associated with the delivery of services and safeguarding of funds (rather than simply accounting for funds and assets) are addressed
- Reporting risk – ensuring that financial and management reports are accurate
- Compliance risk – ensuring that relevant laws, regulations and policies are complied with.

An effective system of risk management and internal controls provides a systematic approach for the efficient achievement of an organisation's objectives, while reducing downside and rework.

Best practice models suggest the following:

- Management is responsible for establishing and managing these systems of risk management and internal controls
- The Board and relevant sub-committees are responsible for overseeing these risk management and internal control systems
- Internal Audit provides the Audit Committee and executive management with independent assurance that these systems and processes are in place and working appropriately.

Internationally, in all sectors, there is an increasing trend for these practices to be put in place. These practices have been driven as much by experienced boards and executives as they have been by regulators. As a result IIA-Australia takes these aspects as better practice.

*Recommendation 5: NFP Directors and Officers be required to put an effective system of risk management and internal control in place. Management should be required to report to the Board or relevant sub-committee on the effectiveness of these systems, and provide sufficient reporting to allow the Board to understand the material risks facing the organisation and ensure that appropriate actions have been taken. While some leading NFPs will already have this in place, regulatory intervention may be required for this to occur across the sector.*

*Recommendation 6: NFP organisations be encouraged to put an internal audit activity in place to give an independent view on the veracity of the organisation's risk management and internal control systems.*

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<sup>3</sup> Adapted from: *Enterprise Risk Management – Integrated Framework* COSO, 2004

## COMPETITIVE NEUTRALITY

Many NFP organisations including our own engage in commercial activities in order to subsidise their services to members and beneficiaries. While we do not believe it is IIA-Australia's place to comment on competitive neutrality issues, the Inquiry should note that any significant changes in this area have the potential to impact the commercial viability of many NFPs. Given the importance of NFP service delivery to the Australian community and the economy, long-term transitional arrangements may be appropriate to avoid disruption to NFP services if any changes are made in this area.

*Recommendation 7: Caution be applied if any significant changes are to be made to competitive neutrality arrangements, including long-term transitional arrangements as appropriate.*

## REPORTING TO BENEFICIARIES

We note that members and benefactors are keen to understand what proportion of their contributions goes to direct service delivery rather than being absorbed into fundraising costs and other overheads.

In reviewing this area, we suggest that the Inquiry may wish to look into the idea of a Management Expense Ratios (MER) being available and required to be disclosed at the time of the transaction by a member or benefactor, rather than only being available in the Annual Report. This would be consistent with MER disclosures on other products such as superannuation and managed investments.

If this suggestion is to be explored, this would require appropriate accounting pronouncements to enable comparability between different organisations.

*Recommendation 8: Disclosure of management expense ratios at the time of transaction be explored as an option to ensure transparency to members and benefactors. Such ratios should be governed by an appropriate accounting standard and audited as part of the statutory external audit. As such it may make sense for these ratios to be provided based on the most recent set of audited financial statements.*

## SIZE AND NATURE OF NFPs

As previously stated, the goal of most NFPs should be on high performance for the benefit of their stakeholders which should be supported by effective governance without excessive management and governance costs.

We acknowledge that some of these recommendations may be difficult to implement for small NFPs. While it is tempting to introduce financial thresholds after which these measures should apply (and by implication below which NFPs do not have to comply), IIA-Australia believes that most of these measures are reasonable and should be achievable by smaller NFPs.

Other factors should be considered if financial thresholds for compliance are to be introduced. These may include whether the NFP raises money from the public, whether donors have a say in how these funds are applied, how these are disclosed and a range of other matters.

*Recommendation 9: If financial thresholds are to be introduced for compliance, other measures which should reasonably draw an organisation into compliance irrespective of financial metrics should be considered.*

## ABOUT IIA-AUSTRALIA

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Australia our membership is made up of internal auditors in government, the corporate sector, and public practice.

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IIA members are required to ensure that internal audit work is performed at a high standard through compliance with IIA's global Code of Ethics and Professional Standards. Internal audit and related matters are highly specialised. The IIA provides timely and relevant guidance available to ensure that IIA members are up to date with local and global issues and operating at the highest standard. IIA-Australia provides a range of guidance on these matters at [www.iaa.org.au](http://www.iaa.org.au).

For more information on this submission, please contact: Todd Davies, Technical & Policy Director on (02) 9267 9155.